addition to other costs. The Act specifically says marketing, billing, collection, and other costs that will be avoided. In the area of marketing and billing costs, those costs are specifically included in here—marketing costs, product management, sales, advertising—are the costs that are referred to in the Act.

Now, BellSouth has taken a position that is not specified anywhere in the Act. Very many times they'll make note of the fact that if it's not volume sensitive, they're not going to look at that specific cost even though the Act referenced marketing costs. And I'll go back to the example Mr. Gillan mentioned earlier with respect to advertising, that because they don't intend on reducing their advertising costs and it's not volume sensitive, then it's obviously not something that should be considered. They're not taking into consideration that there are many costs that even though they may not be sensitive to volume, provide no benefit to the resellers, and advertising is specifically one of those types of costs.

So, when we look at the costs, we're looking specifically at those costs that are retail related. Why? Because AT&T is going to be performing the retail functions when it performs its own resale, and it would be inappropriate to include in any of the wholesale rates retail costs for BellSouth. It would be a duplication.

AT&T's rates would have to recover its own retail rates and BellSouth's, it would be inappropriate to continue to include those in there.

To the extent that there are costs that will not change because of volume sensitivity, or for whatever reason, competition will force them to relook at that, and I think that's one of the most important things that needs to be looked at. So, the AT&T model looks at it from the standpoint of all retail related costs.

I might mention also that Mr. Reid also mentioned, with respect to AT&T's model, and as to how it addressed the criteria of the FCC, that we took liberties with changing what the FCC did, and he mentioned specifically the use of 90 percent avoided for certain categories. Well, I might mention that the FCC avoided cost criteria has a section there for development of interim rates, and if a Commission did not have any specific costs from which to make a final decision, it could set interim rates. And there were default rates, like the 90 percent, that were included in there. There were some calculations that were used by the FCC solely for the purpose of developing interim rates. But in the FCC, there's a paragraph in there, I believe it's paragraph 909, that says, that there is broad latitude provided to the state commissions to look at what the actual costs are and not be driven by default calculations. And that's what AT&T, you know, attempted to do in its Cost Study, in particular with respect to indirect costs. That was one of the areas that AT&T looked at what's actually happening and not what could be happening.

With respect to access, Mr. Reid mentioned that AT&T used some BellAtlantic information. Well, I'll grant you that when we put this together, there was no publicly available access information that BellSouth had at the time. We used some BellAtlantic methodology, applied to specific South Carolina costs for BellSouth, to come up with what those access costs were, and at a later time we have received information from BellSouth indicating what they felt were their access costs. I've done some sensitivity analyses, and the percentage reduction of our discount calculation, our proposed discount is 26.16, and using the numbers that come out of their model, it dropped less than one percentage point. It had almost no impact. It helped support the fact that we were using numbers that shouldn't be much different because the cost of provisioning access from BOC to BOC shouldn't be that significantly different. But their's was publicly available at the time and BellSouth's information was not, and that was one of the reasons that we used BellAtlantic methodology, but it was used with South Carolina information.

Very specifically, the approach that AT&T is taking, as I stated yesterday in my summary, is that we have costs that will be avoided, both direct and indirect, divided by the revenues subject to resale, and we've included all the appropriate retail related costs as avoided.

Q *[Mrs. Taylor]* I'll put the same question to you as I did to the BellSouth panel. Does your methodology take into account that an incumbent's rates are not necessarily cost based and might reflect some social pricing considerations?

A *[Mr. Lerma]* The methodology that AT&T has used is the methodology that's specifically called for, both in the Act and consistent with the FCC procedures, and we look at the revenues subject to resale as they are and the costs as they are. I think, similarly, with the comment that Mr. Reid made, there was no distinction made whatsoever with respect to whether services are above cost or below cost because what we're looking at here, it should be a one-for-one wash, you know. If a service is below cost today and there are political decisions or subsidies that have been made over time to take care of that situation, that's an unchanged situation as a result of just this one action. What we're looking at here is that, if there's $100 in avoided costs, revenues will be reduced by $100, and nothing changes. So, with that respect, there was no additional adjustments or modifications made.

Q *[Mrs. Taylor]* Does either panel have an opinion as to whether there are any universal service considerations in relation to the wholesale rates?

VICE CHAIRMAN BRADLEY: Mr. Kaserman?

A *[Dr. Kaserman]* The two are related and related to the question that was just asked about the social pricing and wholesale for subsidized services. What it comes down to is this: if you don't provide a discount on subsidized services, you will not have any entry into the subsidized market. So, by attempting to protect these people, what you end up doing is denying them the benefits of competition. You have to have a wholesale discount; otherwise, you have no entry, facility based or wholesale.

This is discussed in my testimony on pages 40-43, and what Mr. Lerma said, I think is correct. It is certainly related to universal service. You need to reform the method through which you ensure universal service to make it competitively neutral in this new environment and, of course, that's what the FCC proceeding right now is all about on universal service reform. You want to be able to provide to, particularly low income consumers, both: you want to be able to deliver a subsidy to them, and you want to allow them to reap the benefits of competition; and you can do both by providing a discount on subsidized services and then providing a competitively neutral universal service mechanism.

A *[Mr. Varner]* I think that it's a little bit more direct effect as a result of that. First, residence service is generally subsidized and let's take, for example, you have a $15 1FR and assume it costs $30, for the basis of talking. If AT&T resells that $15 1FR rate, they will be charged the $15 less whatever the wholesale discount is. So they will, in effect, be able to continue to serve that subsidized customer at a rate that reflects a discount off the subsidized rate. It will be $15 less the wholesale discount.

Now, if that wholesale discount is specified properly, such that the amount of that wholesale discount is only equal to the costs that we actually no longer incur as a result of AT&T selling that service to the end-user versus our selling the service to the end-user, then there is no additional cost deficit created. And that, I think, is what the Act had in mind and what it envisioned.

But let's take, for example, that for that customer who we get $15 from, when AT&T now sells the service to that customer, we only reduce our cost by $1.00 but AT&T gets a $2.00 discount for selling that service. There is now an additional $1.00 cost deficit that will have to be made up from some place. Now, where will that deficit ultimately reside? It will ultimately end up going back to the remaining customers that BellSouth has on its network. Its remaining end-users will have to not only pay the subsidy that was previously going to those customers, but also the additional subsidy that's now being provided by AT&T.

I think that's why it's important that resale discount really only reflect the costs that actually do go away as a result of having that customer, providing that customer with resale versus providing him directly, because if it doesn't, it creates an additional cost deficit that further threatens universal service.

A *[Ms. Winegard]* Universal service will be one of the most critical issues that this Commission and other commissions have to deal with going forward, but I do have to respond to Mr. Varner.

Remember that the average residential customer in South Carolina is a profitable customer for BellSouth, and the reason is, customers don't typically just buy the basic flat rate residential service; they buy vertical features, they buy long distance service, they buy a whole host of other services, so that the average customer is a profitable customer for BellSouth. The average customer, when we purchase a BellSouth service for resale, we're not going to be purchasing just the 1FR, and there has been no proof that the 1FR line is, indeed, below cost. That will be something that you will need to look at in the universal service proceeding.

VICE CHAIRMAN BRADLEY: Briefly, Dr. Reid.

A *[Mr. Reid]* I just wanted to point out one fact regarding the discount. The use of the total revenues subject to resale as the denominator of the equation basically means that it's applicable to average customers. For example, the 10 percent would be applicable to an average revenue generating customer, say, $100 a year—would be $10 of savings. To the extent that AT&T or other resellers decide to target our high revenue customers, we will lose a whole lot more in revenues, which will have to be made up by the rest of the customers, than the costs that we will avoid because the cost for serving a high revenue customer doesn't go up proportionately.

MS. TAYLOR: I think at this point it would be if the Commissioners have any questions regarding the wholesale discount.

COMM. SCOTT: Mr. Chairman?

VICE CHAIRMAN BRADLEY: Go ahead.

EXAMINATION BY COMMISSIONER SCOTT:

Q This is for both panels. Has any BellSouth state adopted a discount as high as AT&T is proposing in this case or as low as BellSouth is proposing in this case?

A *[Ms. Winegard]* I can tell you specifically. The answer to your question is no. However—

[*Laughter*]

Q [*Comm. Scott*] That's fine.

A *[Ms. Winegard]* The discounts tend to be much, much closer to the discounts proposed by AT&T than those proposed by BellSouth. In Louisiana, the discount is an overall 20.3 discount rate. When I say *overall,* I mean both business and residential services.

Q [*Comm. Scott*] Ms. Winegard, that's fine. The only question was, *has anybody adopted one as high as 26.1*—and the answer to that is no?

A *[Ms. Winegard]* The answer to that is no.

Q Okay.

A But your question was specifically BellSouth as opposed to around the Country?

Q Right. I don't mean to cut you off, but I've got the list there that you're going by.

And none is as low as what BellSouth proposed?

A *[Mr. Varner]* That's correct. We would also note not as high as what AT&T proposed.

Q Thank you.

CHAIRMAN BUTLER: Any other questions

from the Commissioners?

COMM. SCOTT: Can I ask a follow-up?

Q [*Comm. Scott*] So, would the answer be that the rates fall somewhere between the two?

A *[Ms. Winegard]* The rates are much closer to the rates proposed by AT&T.

A *[Mr. Varner]* I disagree with that.

[Laughter]

Q Thank you.

A *[Mr. Varner]* They are somewhere between the two, is where they come out typically.

Q Thank you.

CHAIRMAN BUTLER: Mrs. Taylor?

MRS. TAYLOR: Thank you.

Q *[Mrs. Taylor]* Regarding Issues #21 and #22, obviously these are very complex issues. So, at this point, I would give each panel just a couple of minutes to summarize any positions that they may want to point out to the Commission, as a summary. And we could begin with BellSouth.

A *[Mr. Reid]* From a summary standpoint, I would like to reiterate that BellSouth's Study is based on actual South Carolina data by work activities, an analysis of those costs that will be avoided. And we have provided, in addition to that—that Study would produce discount rates of

10.4 percent for residence and 9.2 percent for business services.

However, following the FCC's rationale and its criteria in its Order, also doing a very detailed Study of work activities, the 13.2 percent wholesale discount rate would be the one that would be produced. So that would be the upper end of the reasonable discount rates based on BellSouth's analysis of its actual costs.

A *[Mr. Lerma]* With respect to the model that AT&T has put forward in this case, we have relied upon 1995 actual costs as submitted by BellSouth to the FCC in its ARMIS Reports. These are publicly available, they can be easily verified and audited as such. The information that is relied upon by BellSouth, as they mentioned, was at a work activity level. It is not easily verified. It's proprietary data and difficult to review. And, in addition, as I stated earlier, the information, although it's mentioned as being 1995, was actually put together from a sample of information that was the last three months of '95 and the first two months of '96. So, when you look at those relationships, there is a mismatch with the actual revenues subject to resale that are 1995.

So, I had difficulty with that approach, and many times, in looking at the information throughout this proceeding and in other proceedings, we keep looking for

BellSouth's coming forth with all the costs that will actually be avoided, if they have the work activities available to them, then there shouldn't be any reason why all of the work activities shouldn't be looked at very carefully. And I'll bring just one example of an area where I believe that they missed identifying that it's a cost that will be avoided, for example, it's in the area of testing. AT&T has an adjustment in its model with respect to costs that go away from customer related testing. When a customer has a problem on its line and they want to report this problem, they're not going to call BellSouth, they're going to call AT&T; and AT&T, with the electronic interface that it has with its trouble-reporting database, will do some initial testing to determine where the problems are, whether the problem is in the BellSouth facilities or whether it's on the customer's side. But there are many costs related to that that AT&T will now incur and BellSouth will not. BellSouth didn't even look at that. They had a chart up here that indicated there's some network costs that will not even be looked at, and there is a specific example of one that was overlooked.

And, so, I have difficulty with the information that's been put forward as being respective—reflective, rather—of actual work activities. I do believe that because AT&T relied on public information that is easily verified and audited, that it is more reliable.

Q *[Mrs. Taylor]* Let's move now then to Issue #23 regarding pricing for unbundled network elements. And, again, with the risk of some repetition from your summaries, I would ask that since some of this was covered yesterday, each panel please give a brief overview of your Company's position on this issue. And if BellSouth would like to begin?

A *[Mr. Scheye]* And, again, I will try not to repeat what I talked about this morning; but, in summary, we have used a combination of things to recognize how to price unbundled elements, interconnection and, for that matter, resale. We did that not only to reflect the Telecom Act, the FCC Order, and the fact that the Eighth Circuit has now stayed many of those requirements, so that we're sort of working with a clean slate. So we've used a combination of tariffed rates where they apply to the identical element, and I can give you an example. For example, *Operator Services*. We have rates for those in the tariffs, those cost studies have been submitted to this Commission, and you've approved them on that basis, and we've simply carried that forward as a proper standard.

In addition, there are several items that don't have comparable services today and we have to rely on additional cost data and additional negotiations. For example, in the area of an unbundled loop, which is a critical element, the cost studies yield a number of about $30. Our special access price in the State of South Carolina, which is a comparable capability, is about $25, and that's what we're proposing as a tariff price. But, in addition, understanding the need for unbundled loops, we have proposed a price subject to true-up. It has arisen from negotiations we've had with ACSI and several other parties in the range of $18.

So that we've tried to put forth rates that are reasonable, rates that are cost supportive, and rates that, most critically, will allow competition to evolve in the State of South Carolina.

I can speak for them.

[*Laughter*]

A *[Dr. Kaserman]* I'll keep this very simple. First of all, I think pricing these unbundled elements—these are the most important prices you're going to set to encourage competition in this market. This is going to be the way that entrants are going to get in to provide the most benefit to consumers on the broadest geographic scale. Mr. Varner talked yesterday about the rural customers; the only way rural customers are going to get competition is through efficient pricing of the inputs that competitors need to get into this market, both the wholesale and, even more importantly, the unbundled elements.

Second, what are the efficient prices? The efficient prices are incremental costs. This is a long standing principle in economics, it's been around for a hundred years. Incremental costs do include a normal profit, competitive profit, despite Dr. Parsons' statement to the contrary.

It's only by pricing these unbundled elements that you will encourage the new firms coming into the market to make efficient use of the competitor's network. Why? Because it is the incremental cost of building the network that they face. They don't have the network now, so it's the incremental cost they face when they're making their decision whether to build the network, and you want them to compare that incremental cost to this Company's incremental cost of providing the existing network elements to them; only then do you get both efficient entry decisions and efficient decisions about how extensively to utilize the existing network and thereby minimize problems of stranded investment and the like.

Thank you.

A *[Mr. Ellison]* I would like to add to that. As Dr. Kaserman states, that is our general position on pricing.

I'd like to go back about a year and a half ago to Bell's alternative regulation proceeding in this case, and there was much discussion at that time about what the appropriate pricing standards should be for BellSouth services. At that time, BellSouth was very adamant in its position that any price that met its long run incremental cost was an appropriate price for its services; and, in fact, BellSouth advocated pricing below the long run incremental cost in the case that they faced competiton for a service.

Now, the long run incremental costs that BellSouth talked about is different than total service or total element long run incremental costs, to the extent that it is generally a lower cost because it does not include shared costs, common costs, that are in the TELRIC studies. And I'd just like to briefly read, if I could– I'll be glad to provide this to the Commission–this is a data response that BellSouth provided in Georgia on the same subject. BellSouth said:

> If the service is priced above LRIC, that is, covering all the costs that are directly attritutable to the service, and making a contribution to the shared costs of the firm, if the price of a service is above its LRIC, then the firm is better off producing the service because it is covering the direct cost of the service and getting contribution for the shared

costs of the firm.

That's been BellSouth's position in the past, so, if I could, with that, just move on to the costs that BellSouth has provided in this proceeding—they have provided TELRIC studies which developed costs which are higher than the LRIC studies that they talked about before. Generally, there is not a lot of debate about the studies that BellSouth has presented versus AT&T. If you look at BellSouth's cost studies and you make appropriate adjustments in those cases where they've overstated costs—and that's primarily in the loop area—the results of their studies match up pretty well with the Hatfield results. So, when the Company says Hatfield has all these problems, I don't understand that, because the results of BellSouth's studies and the Hatfield results are very comparable.

The problem we have with BellSouth's proposal is not their costs as adjusted; it's the prices they propose. And if I could just go through those, I'll just go through four real quickly just to give you a feel for it, if I could. On *Local Switching*, BellSouth says their total element long run incremental costs, including a profit and including a loading for common costs of the Company and including a loading for all attributable and shared costs of providing the service, is about two-tenths of a cent per minute, or about $2.00 per thousand minutes. But Mr. Scheye proposes a rate of $8.21 per thousand minutes, and Mr. Scheye supposedly based this on cost. Well, BellSouth's own Study says the costs are only a fourth of that.

I'll quickly just go down: *DA Call Completion* is another one. The Company says it costs them two cents, including a profit, to complete a DA call; but they propose to charge AT&T twenty-five cents. That's about 1250 percent above the Company's stated TELRIC cost.

DS-1 Interoffice Channel. The Company's cost in other states—they haven't provided one in South Carolina—in other states, their studies range from about seventy cents to $1.00 per mile for that facility. In South Carolina, they propose to charge $23.00 per mile, versus $1.00.

And, finally, on *Intercept Services,* the Company says its cost is less than a penny per minute to handle an intercept call; but, again, the Company says based on cost estimates, it wants to charge AT&T twenty-five cents for the same service. It costs less than a penny; the charge to AT&T, twenty-five cents.

So, I guess in summary, I want to say that the Commission really needs to focus on the fact that when BellSouth says it wants to use existing tariffs, its own studies demonstrate those tariffs greatly overstate the cost of providing the service, including a reasonable profit. And all AT&T is proposing is that this Commission determine BellSouth's reasonable forward looking costs, including reasonable profit, as determined particularly by the FCC Rules, which fully compensate the Company for its cost to provide a service, and to establish rates based on those costs. And my Exhibit WE-1 provides the Commission a lot of information on BellSouth's costs and AT&T price recommendations.

Thank you.

Q I think you would be entitled to a response at this time.

A *[Dr. Parsons]* Two things. Number one is, economic theory for the last hundred years has also suggested that firms do have to cover their total cost. When those two principles are at odds, when you have circumstances where they can't exist, there's a whole body of economic literature that discusses that. The principle which wins out is the principle that firms cover their total cost; the whole discussion about things that are called — That's multi-part pricing, a lot of technical things. That's the principle that wins out. In business and in economics, firms don't survive unless they cover their total cost.

Second, with regard to what Mr. Hamman[*sic*] described as AT&T's position doesn't appear to be their position consistently. In a Canadian Docket 94-52, in 1995, an AT&T witness, in that docket, AT&T was intervening to testify to suggest that long distance prices in Canada should be higher. The testimony there by Mr. Borger, an AT&T witness testifying on behalf of their affiliate, presented embedded cost data for AT&T suggesting that was what should be examined and that, in fact was what was examained by AT&T officials as high as Mr. Allen. He recommended the Canadian Commission examine the embedded data, and they recommended that a margin as great as nine to twelve cents on top of after you netted it out for access was what was necessary for a company to survive.

So, the incremental cost standard is not something that is ubiquitously used, as AT&T for their position, in contrast to what Mr. Hamman[*sic*] said.

VICE CHAIRMAN BRADLEY: Yes?

A *[Mr. Varner]* We started off with a discussion on pricing, and we ended up talking about cost, so I assume we'll get there later, but there are a couple of points I think I needed to bring out.

First, I was also there in that proceeding Mr. Ellison referred to, and I think the Commission's Order in that proceeding speaks for itself. We did not maintain that prices should be set at long run incremental cost; what we did say is that that was a floor for prices, that was the lowest level that we should be allowed to go except in unusual circumstances in order to meet competition. What you've heard is an attempt to take a floor and turn it into a ceiling in this proceeding. The position that they've had is that that should be the ceiling for the price; not the floor; and, as this Commission has already found, the long run incremental cost is an appropriate floor.

The existing tariff rates that we're talking about using are tariff rates that this Commission has already approved. The Commission has looked at the cost, they've looked at the market, they've looked at the circumstances under which those services are offered, and they've determined that those rates are appropriate and those rates are reasonable. That's why we're using those rates in this proceeding. What relationship those rates may have to cost, the Commission has made a determination that that's appropriate. So, to the extent that we're using tariff rates, that's already been determined.

I found it quite interesting when Dr. Kaserman was talking, a couple statements, that the only way a rural customer would get competition is through the use of unbundled elements and resale. There is another way that a rural customer could potentially get competition, and that's through investment by AT&T in its own facilities. I notice that was not mentioned in his comments.

And that's the point that I wanted to bring up to you: that, as you go through this and as you start to create the set of incentives and the set of prices for unbundled elements, resale services, and so forth; as a policy matter, when you step back from this, I would think what you would want to do is create the environment that will bring the best benefits of competition to all customers in South Carolina. And the way to do that is to encourage and incent investment—investment by BellSouth and investment by AT&T and the other new entrants. And the way to do that is to set the resale discounts appropriately and set the prices for these unbundled elements at reasonable levels such that they're not creating just a subsidy for AT&T, wherein they have no incentive to ever invest in South Carolina. I don't think that's the policy that you want. I don't think that's the outcome from competition that you want.

Thank you.

VICE CHAIRMAN BRADLEY: Briefly.

A *[Mr. Gillan]* I'll be very brief. I wanted to respond directly to the argument that says that because you have tariffed services, you should use those prices for network elements, and I won't use my own words, I will use those of BellSouth, because this issue came up in Florida where a group of intervenors asked BellSouth to provide them the cost studies of their existing tariff services so that those cost studies could be compared with the cost studies for network elements, recognizing that their own services are created by network elements; and BellSouth's answer to this intervenor group was, *We will not provide you the cost studies for existing services because:*

> these cost studies are no way relevant to the instant proceedings; the unbunled network elements that BellSouth will be offering to satisfy the Section 251 requirements are provisioned and designed in ways that are different than the provisioning and design of the wide variety of services for which FIXCA—

which is the intervenor group—

> has requested.

Continuing the quote:

> Put simply, there is nothing in this wide range of requested studies that would shed any light upon the costs of the unbundled network elements that BellSouth intends to offer.

So, it cannot be that in Florida these tariffs and these cost studies for existing services shed no light in any way upon the costs of unbundled network elements; yet, their same services and their same tariffs in South Carolina tell you the pricing of these elements.

A *[Mr. Scheye]* I would just make one final point, and that is, those cost studies, in fact, do not have anything to do with unbundled elements. They weren't for the unbundled elements as I was discussing here. I just wanted to leave that for clarification. Thank you.

CHAIRMAN BUTLER: Commissioner Scott?

COMM. SCOTT: Thank you, Mr. Chairman.

Q [*Comm. Scott*] Ms. Winegard, you were responding to a question that I asked and I cut you off, and I've been sitting here feeling badly ever since. Could you please finish your answer?

A *[Ms. Winegard]* You should not feel badly in the least.

Q [*Comm. Scott*] Well, please finish your answer, because I have felt badly.

A *[Ms. Winegard]* I believe I was giving you the resale rates that have been approved in the BellSouth states.

Q [*Comm. Scott*] Right.

A *[Ms. Winegard]* And if you'll give me just a moment to find it. Okay, here it is.

I believe I had given you Louisiana already.

Q [*Comm. Scott*] You said 20.3?

A *[Ms. Winegard]* 20.3 percent.

Q [*Comm. Scott*] I thought it was 20.72; is there some reason mine would be different?

A *[Mr. Scheye]* Yours is right, Commissioner.

Q [*Comm. Scott*] Sir?

A *[Mr. Scheye]* Yours is right, Commissioner.

A *[Ms. Winegard]* Okay. His is higher, I think you are right, and that was set not in the arbitration proceeding, but in Docket No.U-22020; 20.3 was actually Georgia, not Louisiana. I apologize.

The rate that was set in Tennessee was a wholesale rate of 16.0 percent; without *Operator Services* and *DA*, it's 21.56 percent.

In North Carolina, the Order is 21.5 percent for residential, and 17.6 percent for business.

Florida is set at 21.83 percent for residential; and 16.81 percent for business.

And Georgia was, again, not included in the arbitration, it was part of a separate docket; and that was 20.3 for residence, and I believe 18.3 for business. Excuse me, I've been corrected–17.3 for business.

Q [*Comm. Scott*] Tennessee–would you tell me what the difference is; you said 21.56, which I had, then you also used a 16 percent figure?

A *[Ms. Winegard]* Could Mr. Lerma provide that for you?

Q [*Comm. Scott*] Sure.

A [*Mr.Scheye*] Commissioner, I believe I can clarify it for you. It's just a statement of the order. The 16 percent applies if a carrier, if AT&T used its own *Operator Services*; the